ECONOMIC VIEWPOINT

2022 Year in Review

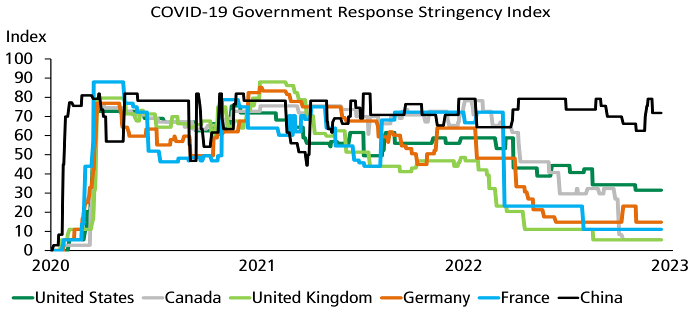
Back to Reality: Soaring Interest Rates, High Inflation and a Housing Correction

The Omicron wave was in full swing at the beginning of 2022, and many countries had just reinstated strict public health measures. But as the year wore on, the urgency surrounding COVID-19 subsided and public health measures were relaxed (graph 1). Those that remain aren't drastic enough to affect economic activity. As a result, consumer habits have shifted and spending on services is up again. The exception is China, where authorities had to lock down major cities this spring and fall. China's zero-COVID policy has been heavily criticized, even at home. It has exacerbated global supply chain pressures and hampered China's economic growth.

Russia's invasion of Ukraine on February 24 was the most consequential geopolitical event of the year. The war shook markets and the global economy and continues to have repercussions today. After a series of economic sanctions and subsequent retaliation by Russia, the prices of several commodities such as oil, nickel and wheat have surged as a result of fragmented and limited global supply. Europe was hardest hit by the price spikes, with natural gas soaring to a record US$260/MMBTU in March—a 250% increase from trough to peak (graph 2). Some commodity prices have since come down, but many remain historically high. The easing of public health measures was partially offset by the sharp rise in the cost of living, especially in Europe. Consumer confidence is down and uncertainty is up in most markets, slowing Europe's major economies.

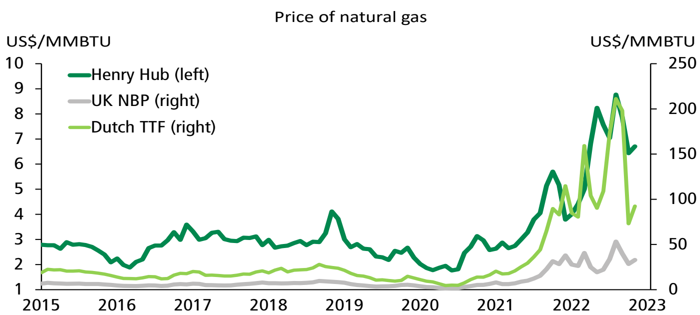
Inflation reached heights in 2022 not seen since the early 1980s. In a context where demand was already relatively strong, the consequences of the pandemic, global supply problems and the rise in commodity prices exacerbated pressures on consumer prices. Headline inflation has been stronger than core inflation, which generally excludes food and energy, but the latter has also been historically very high. The second half of 2022 signalled an easing of some price pressures, particularly on the goods side. However, the rise in service prices remains persistent. This inflationary surge has manifested itself in most

GRAPH 1
Public health measures remain much stricter in China



Sources: University of Oxford, Datastream and Desjardins Economic Studies

GRAPH 2
Natural gas prices skyrocketed in 2022



MMBTU: Million British Thermal Units
Sources: Bloomberg and Desjardins Economic Studies

major economies (graph 3). And Canada is no exception. Excess demand and rising wages due to labour shortages have worked to keep core inflation elevated. High commodity prices have further contributed to decades-high headline inflation, which has put Canadian price growth in the middle of the pack among advanced economies.

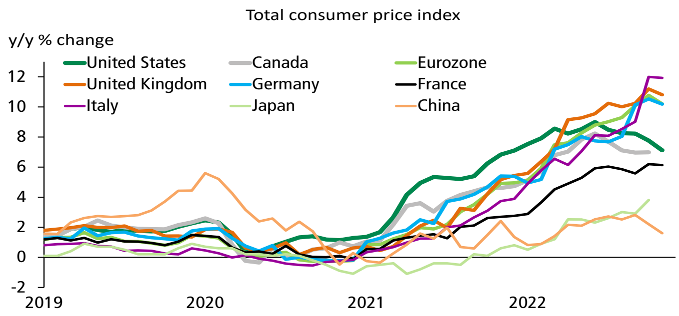
High inflation **forced many central banks to aggressively raise their policy rates** (graph 4). Rate hikes accelerated throughout the year as central banks realized inflation wasn't transitory and was threatening to become entrenched. The Bank of England was among the first to begin tightening, starting in december 2021. The Bank of Canada (BoC) waited until March of this year. The Federal Reserve followed a bit later, while the European Central Bank dragged its feet until early this summer. In Canada, July's 100 basis point (bps) hike was the biggest since August 1998. The BoC raised rates a total of 400 bps between March and December in a bid to wrestle inflation back down to its 2% median target.

After experiencing an extended period of exuberance after the onset of the pandemic, the residential real estate market quickly changed course as interest rates moved higher. Home prices peaked in February but remain well above prepandemic levels. When combined with the rise in mortgage rates, this has caused affordability to fall to an all-time low in Canada. Sales of existing properties also fell sharply, and the market has made an abrupt return to balanced territory. To date, the housing markets in Ontario and BC have seen some of the largest corrections, although no province has been spared. In Quebec, the drop in prices began two months after Canada. The peak was reached in April and the decline of 6.4% through November 2022 is more limited than in most other provinces (graph 5). However, housing starts fell by around 10% in Quebec in 2022, while they held up better in Canada.

One of the economic bright spots in 2022 has been the labour market. In Canada, the unemployment rate hit the lowest level on record mid-year, and has only moved marginally higher since. At the same time, employment gains were decidedly more mixed, with strength in the first half of the year due to reopening after a final pandemic-related lockdown followed by general weakness. When combined with a job vacancy rate that is twice what it was before the pandemic against the backdrop of decades-high inflation, it's no surprise that wage growth was elevated in Canada for much of 2022.

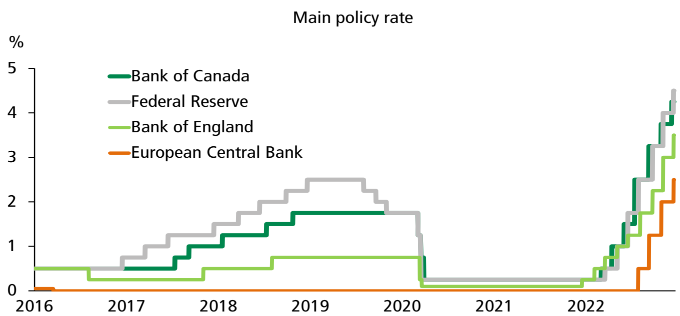
In Quebec, public health measures in place early this year drove the unemployment rate up to 5.4% in January. But the subsequent easing of public health measures and strong demand for workers quickly sent the unemployment rate back down. It hit 3.8% in November, the lowest of any Canadian province (graph 6 on page 3). The labour market remains tight in Quebec, and wage growth is outpacing the national average (graph 7 on page 3).

GRAPH 3
Inflation has soared in virtually every major economy



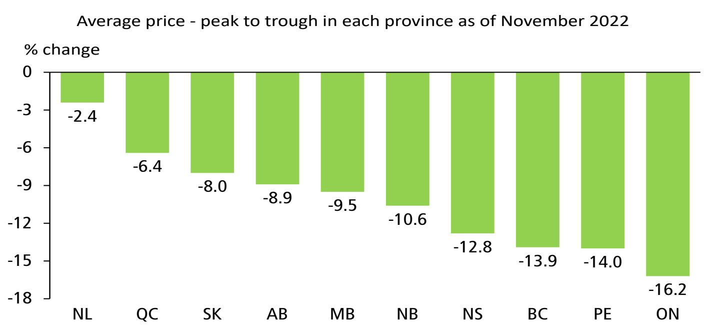
Sources: Datastream and Desjardins Economic Studies

GRAPH 4
Interest rates have risen dramatically



Sources: Datastream and Desjardins Economic Studies

GRAPH 5
Home prices are down nationwide



Sources: Canadian Real Estate Association and Desjardins Economic Studies

Real GDP growth in Canada consistently surprised to the upside in 2022, but the details were much less positive. This was particularly evident in the third quarter, when consumption and investment declined, leaving the strong headline growth number a reflection of just trade and inventories. Real GDP growth in the final quarter of 2022 looks set to similarly surprise, with lagged pandemic-era distortions — like cars finally being delivered — still being felt. However, Canada is a big country and there is a lot of variation in economic activity across provinces (graph 8).

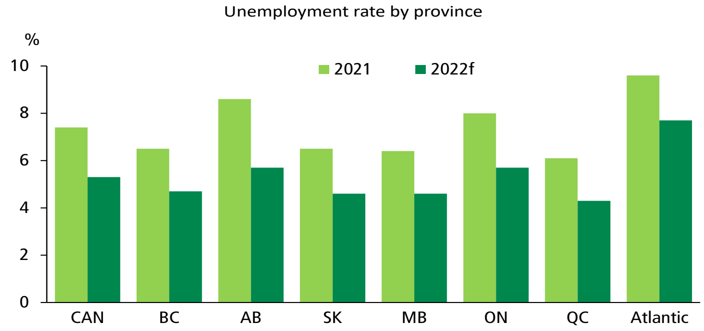
Quebec started out the year with strong economic growth, but since March it has seen a few months of real GDP declines. It's too early to say whether the province is in a recession, although. A number of other indicators point to an economic downturn as well.

We generally saw the strongest economic results in commodity-producing regions as price gains drove strong profitability and increases in export and manufacturing shipment values this year. Alberta was a standout with record oil production, much stronger drilling (graph 9 on page 4), surging in-migration from other provinces, and its best year-over-year rate of job creation since 1981 as of November. By contrast, Ontario's economy got off to a strong start but later witnessed three consecutive monthly employment declines as interest rates jumped and the housing market plunged. Saskatchewan and BC benefited from major project activity.

Solid real GDP growth and high inflation in Canada in 2022 supported outsized government revenue surprises across the country. This led to significant reductions in planned budget deficits and debt issuance. At the federal level, it created room for modest new spending targeted to low-income households. However, the real action was in the provinces. In FY2022, surging revenues helped Canada's provincial governments collectively run a surplus for the first time since before the Great Financial Crisis (graph 10 on page 4). In their mid-year updates, Quebec, Ontario, Alberta, and BC raised FY2023 own-source revenue projections a combined $38B (10%) versus plans released just six months ago!

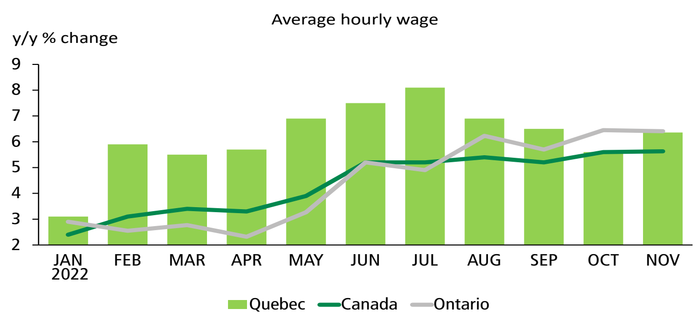
Investors and savers will be happy to turn the page on 2022. In a year of high inflation and rising interest rates, nearly all asset classes have taken a hit, making it an especially gruelling race for returns. Early in the year, surging bond yields hurt stock market returns, especially for highly valued tech companies. Russia's invasion of Ukraine then added a layer of uncertainty. Bond markets didn't provide their usual safe haven as the steep rise in yields sent bond values tumbling.

GRAPH 6
Quebec had the top performing labour market in Canada in 2022



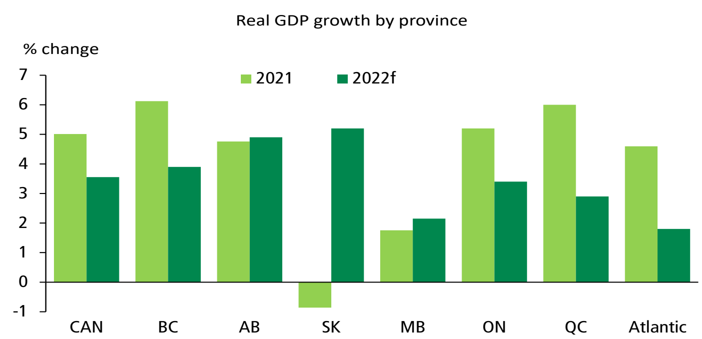
Sources: Statistics Canada and Desjardins Economic Studies

GRAPH 7
Quebec had the fastest wage growth until this fall



Sources: Statistics Canada and Desjardins Economic Studies

GRAPH 8
The West posted the strongest economic growth in 2022



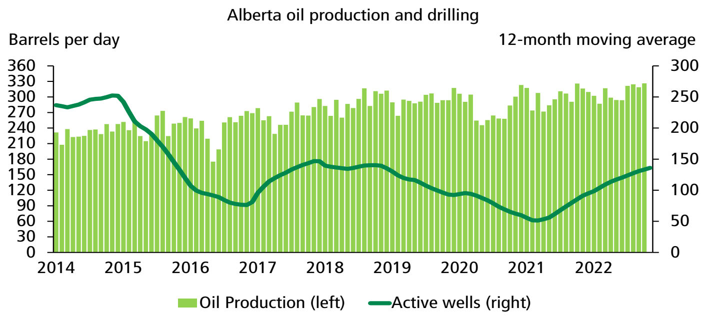
Sources: Statistics Canada and Desjardins Economic Studies

The war in Ukraine hit European stocks the hardest, while China's economic struggles pulled Asian indexes lower (graph 11). Losses were more limited on the Canadian stock exchange. The S&P/TSX posted gains on soaring energy prices as oil companies in Western Canada raked in record profits. Late in the year, markets rebounded on lower inflation numbers and signs of an impending slowdown in rate hikes. But the outlook for returns remains highly uncertain as global economic conditions deteriorate.

2022 also saw **the return of investor vigilance with regard to public finance decisions**. In September, the UK government announced a mini-budget laying out a significant increase in borrowing and a suite of potentially inflationary measures. Worried investors responded with a sell-off of government debt. The pound sterling fell to US$1.04, its lowest point since 1985, while bond yields surged, forcing the Bank of England to intervene. But after a new prime minister took over and most of the announced measures were scrapped, calm was restored within a few weeks.

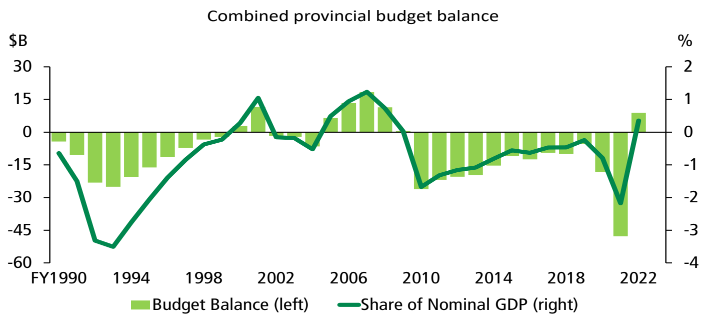
2022 was a tough year for investors, but it has been even worse for those who bet on cryptoassets like Bitcoin, Ethereum and Dogecoin. We saw a sharp correction in most cryptoasset prices (graph 12). There was even a collapse in some stablecoins, which are generally designed to maintain a steady price, and many crypto companies even went bankrupt. There appears to be a number of reasons behind this volatility. Many cryptoassets are actually intangible assets with no real economic utility, making it difficult to assign them a value based on concrete data. Lack of regulation and rigorous auditing is another criticism. Fortunately, no major financial institution had massive exposure to this extremely volatile market. This cautious approach has spared the global financial system as it faces heightened economic uncertainty.

GRAPH 9
Oil and gas sector activity was up sharply in 2022



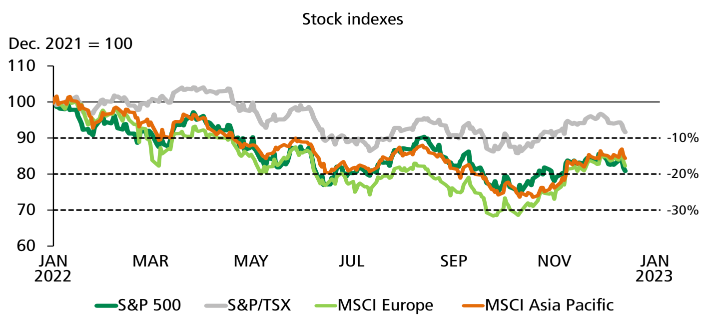
Sources: Alberta Energy Regulator and Desjardins Economic Studies

GRAPH 10
Revenue windfalls drove the first provincial surplus since before the Gobal Financial Crisis



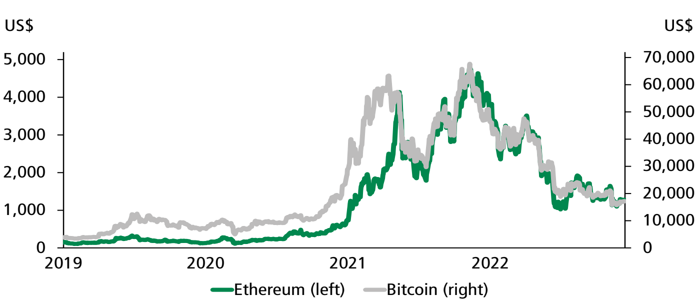
FY: Fiscal year.
Sources: Finance Canada, Statistics Canada and Desjardins Economic Studies

GRAPH 11
Global stock indexes had a tough year in 2022



Sources: Datastream and Desjardins Economic Studies

GRAPH 12
Crypto prices have collapsed again



Sources: Datastream and Desjardins Economic Studies